1.01 FASB Standards & Frameworks

Financial Reporting Frameworks

Financial reporting frameworks (FRFs) may be general purpose frameworks or special purpose frameworks.

- Publicly held entities are required to submit their F/S to the SEC prepared in accordance with a general purpose framework, either GAAP or IFRS.
- Nonpublic entities, however, have a greater number of choices and select a framework that fairly balances the needs of their F/S users and the cost of providing information. Like public entities, nonpublic entities may prepare their F/S under either GAAP or IFRS; however, they also may use a special purpose framework.

A financial reporting framework (FRF) includes:

- **Recognition criteria** that determine what will appear on financial statements (F/S) and when it will appear.
- **Measurement criteria** that determine the amount at which it will be reported.
- **Presentation criteria** that determine where it will appear on the F/S.
- **Disclosure criteria** that determine what information and how much information must be provided to F/S users.

General Purpose Frameworks

There are currently two general purpose frameworks:

- U.S. Generally Accepted Accounting Principles (GAAP)
- International Financial Reporting Standards (IFRS)

> The Financial Accounting and Reporting (FAR) exam tests the CPA candidate's knowledge of how transactions, events, and circumstances are accounted for and how they are reported upon. Most FAR questions are based on U.S. GAAP.

Special Purpose Frameworks

A special purpose framework is an FRF other than GAAP or IFRS. Statements prepared under a special purpose framework must have modified titles showing the basis of accounting—for example, "Consolidated Statements of Assets, Liabilities and Equity (FRF for SMEs Basis)." There are numerous special purpose frameworks:

- **Cash Basis**
  - Revenues are recognized when they are received, regardless of when they are earned.
  - Expenses are recognized when they are paid, regardless of when they are incurred.
  - Fixed assets are expensed and not capitalized.

- **Modified cash basis** is considered a sort of *hybrid* approach between cash and accrual, where assets could be capitalized and taxes and inventory could be accrued.

- **Tax Basis**
  - Revenues and expenses are recognized for financial reporting purposes in the same periods and in the same amount as they are recognized when the entity is preparing its income tax return.
  - The tax basis could be cash-basis or accrual-basis.
- **Contractual Basis**
  - May be required to be used by a party to a contract.
  - Generally designed to assist users in determining whether or not terms of the contract, and other requirements related to it, are being adhered to.
- **Regulatory Basis**
  - May be imposed by a governmental regulatory agency to which the entity is required to report.
- **FRF for SMEs (**Financial Reporting Framework for Small- and Medium-Sized Entities)

With the exception of the cash basis of accounting and in some cases the tax basis, both general purpose frameworks and most special purpose frameworks apply the **accrual basis** of accounting. Under the accrual basis, revenues are recognized in the periods in which they are earned, regardless of when they are received; and expenses are recognized in the periods in which they are incurred, regardless of when they are paid.

> The CPA exam periodically includes questions that require the candidate to determine the amount of revenue or expenses that should be recognized on the accrual basis when given the amount of cash received or paid and the opening and closing balances of various accrual accounts, or changes in them. This will be covered in detail later in the course.

A closely related topic is the statement of cash flows. In order to prepare the statement, the amounts of revenue and expense items determined under the accrual basis are generally known and the amounts of cash received and paid must be determined, a common area of testing on the CPA exam. The process to be applied, discussed later, is basically the reverse of the procedure used to convert from cash to accrual.

Alternative Accounting Approaches for Nonpublic Entities

In order to reduce the cost of financial reporting for **nonpublic entities**, and to bring the cost more in line with the benefits derived by users of F/S, the FASB created the **Private Company Council** (**PCC**). The PCC is charged with evaluating existing GAAP to determine if there are:

- Requirements, including disclosures, from which nonpublic entities should be exempt; or
- Simplified accounting approaches that may be applied to transactions or F/S elements that will reduce the cost of reporting without diminishing the relative value of the information provided.

The PCC has developed alternative accounting approaches for goodwill; certain interest rate swaps (a common form of derivative); for the recognition of identifiable intangible assets acquired in a

business combination; and for potential variable interest entities (VIEs). These alternative accounting approaches may only be applied by a nonpublic entity. To do so, the entity will elect the alternative accounting treatment by including information in its *Summary of Significant Accounting Policies*.

- In the period of adoption, the entity will indicate that it is adopting the alternative treatment and the primary differences between it and the previous requirements.
- It will also be disclosed in subsequent periods, since it represents a choice among acceptable alternative accounting treatments.

An entity electing to adopt the alternative accounting approaches is still preparing its F/S in accordance with GAAP since the pronouncements of the PCC are incorporated into the ASC. As indicated, they apply to nonpublic entities, which are all entities that are not considered public entities. FASB defines *public entities* as those that meet one of the following criteria:

- Submit F/S to the SEC, either as a result of a requirement to do so or do so voluntarily
- Are regulated under the 1934 Securities Exchange Act
- Issue securities that are traded or have securities that are listed on an exchange
- Are required to apply GAAP and have securities that are not restricted as to transfer

FASB Accounting Standards Codification (ASC)

GAAP is developed by the Financial Accounting Standards Board (FASB), who is authorized to establish accounting standards by the Securities and Exchange Commission (SEC). The FASB Accounting Standards Codification (ASC) is the single source of authoritative GAAP for nongovernmental entities. The Codification reorganized thousands of GAAP pronouncements into approximately 90 accounting topics (see Research Appendix for more specifics).

Topic Groups	Numbered
Presentation	200-299
Assets	300-399
Liabilities	400-499
Equity	500-599
Revenues	600-699
Expenses	700-799
Broad Transactions	800-899
Industry	900-999

GAAP hierarchy now consists of two levels:

- Authoritative (in ASC) — updated with Accounting Standards Updates (ASUs), but which are not in themselves authoritative

- Nonauthoritative (not in ASC)

Emerging Issues Task Force (EITF) was created in 1984 by the FASB to reach a consensus on how to account for new and unusual financial transactions that have the potential for creating differing financial reporting practices. The FASB works on long-term problems, while the EITF deals with short-term emerging issues.

FASB Conceptual Framework for Accounting

The FASB periodically issues **Statements on Financial Accounting Concepts (SFACs).** SFACs are not applications of GAAP to specific situations, but instead represent the conceptual framework that guides the development of financial accounting and reporting standards. The conceptual framework defines the objectives and concepts that underlie financial reporting (per SFAC 8).

The **Objectives** of financial reporting (which focus on the **USERS** of F/S) are:

1. **Primary Objective** - To provide information that is useful to existing and potential **investors, lenders, and other creditors** (ie, users) in making decisions about providing resources to the entity.
2. Information about a reporting entity's **economic resources** and claims against the entity (ie, financial position) – *Balance Sheet (B/S)*.
3. **Changes** in economic resources and claims.
4. Financial performance reflected by **accrual accounting** – provides a better basis for assessing the entity's past and future performance than does cash basis – *Income Statement (I/S)*.
5. Financial performance reflected by past **cash flow** – *Statement of Cash Flows*
6. Changes in economic resources and claims **NOT** resulting from financial performance (eg, issuing additional stock) – *Statement of Changes in Owners' Equity*.

We can achieve our objectives if F/S have certain **Primary Qualitative Characteristics** that makes information **useful**. In order to be useful, information must have *both* relevance and faithful representation.

- **Relevance** – Information is capable of making a difference in a user's decision-making process if it has one or both of the following components:

  Roger is **PC.**

  - *Predictive value* – Helps decision makers predict or forecast future results.
  - *Confirmatory value* (Feedback value) – Confirms or corrects prior predictions.
- **Faithful Representation** – The information depicts what it purports to represent. The 3 components are:

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  - *Free from Error* – No errors or omissions in the information.
  - *Neutrality* (w/o bias) – The information is free from bias.
  - *Completeness* – Adequate or full disclosure of all necessary information.

Enhancing Qualitative Characteristics that relate to both relevance and faithful representation:

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- *Comparability* – Same *principles* being used with business enterprises in similar Industry.

- Consistency – Same accounting *methods* in different periods.

- ***Understandability*** – Classifying, characterizing and presenting information clearly and concisely.
- ***Timeliness*** – Information is available to a decision maker when it is useful to make the decision.
- ***Verifiability*** – Different sources agree on an amount through either direct or indirect verification.

Constraints that override the usefulness of information:

- **Cost/benefit** – Cost of obtaining and presenting the information shouldn't exceed the benefit.
- **Materiality** – Capable of making a difference in the *user's* decision-making process if omitted or misstated (auditor's judgment). Considered an entity-specific aspect similar to *Relevance* that applies at the individual entity level.